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C O N F I D E N T I A L SECTION 01 OF 07 PANAMA 002524

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TAGS: ECON ETRD EFIN PTER SNAR PM ECONOMIC AFFAIRS
SUBJECT: UNDERSTANDING PANAMA'S COLON FREE ZONE

Classified By: Ambassador Linda E. Watt, Reasons 1.4(b) and (e)

¶1. (C) Summary: An important pillar of Panama's service-based economy, the Colon Free Zone (CFZ) is the largest duty free zone in the hemisphere and the second largest in the world. Offering much more than just duty-free wholesale shopping, however, the CFZ draws upon the strengths of Panama's world-class shipping and financial services to offer cargo services and credit to its customers throughout Latin America. The 'value added' provided by Zone merchants has frequently amounted to helping customers skirt customs duties and exchange rate laws in the importing country, and law enforcement in the zone is weak. In such an environment, it can be easy to turn a blind eye to more serious criminal activities. In order to improve its prospects for future growth, the CFZ must address its security and law enforcement weaknesses as well as re-examine its entrepot service offering in the context of today's more liberal and globally integrated business environment. The incoming Torrijos administration has already begun to focus on the CFZ's weaknesses by naming a highly respected community activist to the top slot at the Zone, and the Embassy is focusing assets on better understanding CFZ financial flows and exploring ways to work with the CFZ administration to strengthen enforcement. End summary.

Background and Introduction

¶2. (U) In 1948, the GOP set aside a 370-acre area adjacent to the Atlantic port city of Colon for the creation of a free trade zone. Half a century later, the Colon Free Zone (CFZ) is the largest of its kind in the Western Hemisphere and second only to Hong Kong in the world. Originally conceived as a way to modernize Panama's economic infrastructure and encourage regional trade, the CFZ has since developed into a major international merchandise distribution center and a pillar of Panama's service-based economy. Today, the CFZ covers 1,000 acres full of showrooms and warehouses run by hundreds of individual companies. Although the CFZ contributes 7.4% of Panama's GDP, CFZ businesses employ less than 2% of Panama's labor force (17,760 people directly and another 7,000 indirectly). Exempt from many taxes, the CFZ also contributes little to GOP revenues. Zone merchants have vociferously opposed recent proposals to apply even nominal business taxes to CFZ firms.

¶3. (U) In 2003, the CFZ imported $3.990 billion worth of merchandise and exported $4.478 billion. By comparison, the rest of Panama imported 3.070 billion and exported $808 million. The vast majority of CFZ merchandise comes from Asia for distribution throughout Latin America. Broken down by individual countries, the United States is the third most important supplier (9.8% of CFZ imports by value), but a minor customer (4.5% of CFZ exports). Electronics and clothing are the main exports, followed by a wide range of products, including watches, cosmetics, shoes, jewelry, and textiles. Unlike export processing zones which proliferated in Latin America during the 1990s, or truly modern logistics centers like Puerto Rico, the CFZ contributes very little value-added to the physical products it sells, aside from some packaging and labeling for mainly pharmaceutical products.

More than Duty-Free Shopping: Logistics is Now the Key

¶4. (SBU) Currently some 30% of CFZ cargo comes from large logistics operations, and this sector is steadily growing. These are companies who use the CFZ to consolidate products in one place from all their production facilities. For example, Nike brings shoes from various manufacturing centers in Asia and Latin America to the CFZ, and then ships onward to Europe or the United States. However, the CFZ has grown by drawing on the strengths of the financial sector and providing services to smaller merchants in the region. A major international banking center for Latin America, Panama

offers CFZ customers unparalleled access to credit in a stable, U.S.-dollar based economy. Likewise, CFZ commerce benefits from Panama's strengths in shipping, including four world-class container ports, shipping agents, freight forwarders, and, of course, the canal. Adjacent to the CFZ, Manzanillo International Terminal (MIT) is now the largest container port in all of Latin America (in 2003 over 1 million containers in terms of twenty-foot equivalent units, or TEUs passed through MIT). Also nearby are Hong Kong-based Hutchison-Whampoa's Cristobal facility and Taiwan-based Evergreen's Colon Container Terminal. Approximately 60% of CFZ businesses specialize in cargo consolidation, which means that customers can tailor their purchases by buying smaller quantities at wholesale prices and packing them together into single container loads. By comparison, a Bogota merchant buying directly from a Taipei factory would typically confront significant challenges: language barrier, exchange rate risk, no credit, and container lots only.

Financial Woes Lead to Criminal Activities?

¶5. (SBU) There is a symbiotic relationship between the CFZ and Panama's well-developed banking center. Between 80% and 90% of all CFZ business is done on credit of some kind. Twenty-five banks have physical branches in the CFZ. In 2003, banks issued approximately $742 million in credit lines to CFZ companies and buyers. Leaders include HSBC Bank,s portfolio at $133.5 million, Banco Aliado at $62.3 million, BNP Paribas at $60 million, Bank Leum-Le Israel at $50 million, and Bank Boston at $44 million. Accumulated debts within the CFZ approach $1 billion. Buyers from Cuba are most likely to default with more than $200 million in outstanding loans, and Venezuelan merchants have $100 million in CFZ-related debts. As banks have started to tighten their lending controls because of the danger of default, the 250,000 buyers that visit the Zone every year have increasingly looked to other finance channels. CFZ merchants commonly offer the advantage of "flexible invoicing" and 90-day, direct &merchant to merchant8 interest-free credit to help customers to evade import duties and exchange rate laws at the final destination. Anecdotal evidence points to some companies receiving payments in large amounts of cash*no questions asked. Indeed, much of the 'value added' provided by Zone merchants frequently amounts to helping customers skirt customs duties and exchange rate laws in the importing country. In such an environment, it becomes easy to turn a blind eye to more serious criminal activities.

Company and Religious/Ethnic Compositions

¶6. (C) There are 2388 registered companies in the CFZ, and 1716 of those are owner operated. The other 672 are represented by those owner-operated companies. Though no official statistics exist, most observers agree that the companies are broken down along ethnic/religious lines as follows: 30-40% Jewish, 40-50% Muslim Arab, and the remaining 20% equally between Indians/Pakistanis, Chinese, and Panamanian Christians. In general, Arab and Chinese businessmen live in Colon, while Jews and Christians live in Panama City and commute to Colon daily. The Arab businessmen in the CFZ also have maintained historical ties to Arabs in Isla Margarita, Venezuela, Maicao, Colombia, and the Tri-Border Region of Brazil, Argentina, and Paraguay. These ties have raised concerns about possible terrorist financing links, an issue that the Embassy has focused on in the past year. In fact, the Embassy recently created an inter-agency task force to analyze these ties to see if there are terrorist finance links.

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A Bad Reputation; Few Resources; But Some Successes
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¶7. (SBU) CFZ businesses have grown and prospered with little GOP supervision. The GOP's Colon Free Zone Administration has traditionally done the merchants' bidding and lacked resources to implement serious security, law-enforcement, and intellectual property programs, had it been so inclined. In practice, the strongest deterrent to crime--particularly trademark violations or counterfeiting--has been pressure by legitimate merchants in the Zone whose business is affected by illicit activity. Since 2002, the CFZ administration has tried to implement reforms on the law-enforcement and security fronts however, despite counting on just a small staff of lawyers, with only one dedicated full-time to investigating money-laundering and intellectual property

rights (IPR) violations and a security department that numbers only some 80 full time patrollers (four groups of 20 plus 4 bikes and 3 motorcycles), which must control 12 entrances during business hours. Nevertheless, they have played a role in several significant cases, in collaboration with other GOP law enforcement entities and with USG assistance. On the money-laundering front, in the 1999 landmark 'Speed Joyeros' case developed jointly by the GOP and USG over two years, a CFZ jewelry merchant pled guilty to U.S. money laundering charges, forfeited $16 million in seized assets, and opened the door to dozens of arrests in Colombia and elsewhere. The CFZ has also been the source of some very large IPR cases, including the seizure of seven million pirated music and Sony 'Playstation' CDs which were destroyed in December 2003 and nine containers of counterfeit Marlboro cigarettes--over 400,000 cartons valued at $5 million--seized in November 2003. In both cases, counterfeit goods came from Asia transiting the CFZ for distribution throughout Latin America. The large volumes of merchandise trade combined with weak local law enforcement capabilities have made the CFZ an ideal place to conceal criminal activity.

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The Black Market Peso Exchange: Narcotrafficking Connection
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¶8. (C) According to Panama's Customs Authority, every year travelers declare more than $400 million in U.S. currency at Panama's main port of entry, Tocumen International Airport. This number represents declared, "legitimate" currency, and does not/not include smuggled cash. Colombia is the main source of these U.S. dollars at $5 million per month, followed closely by Mexico at $4 million per month, then by other countries in Central American and the Caribbean. The Embassy believes that most of this cash ultimately comes from the United States, possibly in large part as drug proceeds, and is destined to pay off credit lines in the CFZ, and could form part of the Black Market Peso Exchange (BMPE). In this system, a Colombian merchant buys goods in the CFZ on credit in dollars and sells those goods in Colombia in pesos. The merchant then approaches a currency dealer in Colombia who receives the pesos on very favorable terms and arranges for payment of the merchant's debt in the CFZ in dollars from drug proceeds in the United States.

Little Diversification Means Tough Times

¶9. (U) Lack of diversification in its supplier and customer base is a serious concern for the CFZ. Two-thirds of CFZ merchandise comes from Asia, particularly Hong Kong (23.8%), Taiwan (15.2%), and Mainland China (13.0%). The CFZ's customer base is even more concentrated, with most CFZ exports going to Latin American countries, particularly Andean countries: Colombia (14.1%), Ecuador (7.9%), and Venezuela (5.6%). As these Colombia and Venezuela have faced political and economic challenges, so has the CFZ--exports to Venezuela have dwindled by two-thirds since 2001. The relative stability in the past few months in the Andean region has led to a strong rebound in the first half of 2004 for the CFZ however, as exports and imports in the first half of 2004 are up almost 18% and 20% respectively over the same period last year.

¶10. (C) A particular sore spot is Cuba, which is a disproportionately large customer. Cuban government businesses bought $208 million worth of merchandise in 2003 from the CFZ. Recently, CFZ merchants have paid dearly for doing business with Cuba in the form of large overdue accounts receivable, now officially at $200 million, although some unofficial estimates peg the debt as high as $500 million. These debts are so large and touch so many businesses in Panama that CFZ merchants pressure the GoP to restrain its criticism of Castro's policies and even cooperate with the regime in some limited ways, including a bilateral investment agreement, just to ensure continued interest payments and to stave off a Cuban default. In fact, the late August 2004 break of diplomatic relations between the two countries led to immediate protest from CFZ merchants who feared the non-payment of outstanding debts.

¶11. (U) Weaknesses in its supplier and customer base caused the CFZ to shrink by 20% in 1999 after the Asian financial crisis and the Mexican peso crisis. The CFZ is still far from recovering to previous levels due to economic downturns in its principal customer countries like Venezuela and Colombia. In 2003, imports decreased by 10.4% and exports by 7.1%, resulting in an overall 9% contraction on 2002. So far, attempts to promote the CFZ among potential users in the

U.S., Canada, and Europe have met with little success, in part due to its reputation for weak law enforcement.

¶12. (U) Since much of CFZ trade is from Asia to Latin America, the Free Trade Area of the Americas (FTAA) and the ever-increasing sub-regional FTAs do not constitute an immediate threat to the CFZ. Moreover, as the duty-free nature of the CFZ,s trade with regional customers is only one of various CFZ attractions (easy credit and cargo consolidation being more important), a general lowering of tariffs across the region should not hurt the CFZ terribly.

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Multi-Modal Hub of the Americas: Caught in Corruption
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¶13. (SBU) In 2000, CFZ Administrator Jorge Fernandez began promoting an ambitious plan to double the size of the CFZ to include the adjacent MIT and Evergreen ports, the newly-opened Panama Canal Railway cargo terminal, and an international airport with a high-tech industrial park to be developed on the site of the current France Field municipal airstrip -- all in one duty-free customs area. Eschewing normal competitive bidding procedures, the GOP drafted a concession through direct negotiations with the San Lorenzo Consortium (CSL) to develop both the industrial park (CEMIS) and a major international airport (CIASA) that would eventually require over $400 million in new private investment. The CSL concession sparked much controversy. Shortly after it was given final approval by the National Assembly in 2002, a legislator publicly accused the project promoters of bribing a handful of his colleagues (including himself!) in the legislative Assembly. The resulting investigations and media frenzy have all but halted project implementation, and more than two years later the case is no closer to real resolution.

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Comment: Embassy Actively Engaged; CFZ Future Unclear
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¶14. (C) The Embassy has increasingly focused on the CFZ; making it a key part of our broader initiative to engage the Colon community in the past year. We have assisted with law enforcement training, resources, and help with police expenses related to IPR court cases. NAS has donated computer equipment to help the CFZ administration to computerize all transactions and thus more effectively screen for suspicious activity. As noted, the Embassy's recently formed, interagency financial task force is focused on getting a better understanding of the monetary transactions that take place in the Zone.

¶15. The CFZ remains an important pillar of Panama's service-based economy, but its future is uncertain. The CFZ has been slow to change old business patterns that rely on unstable markets and has turned a blind eye to possible criminal activities. Surely, most of CFZ's multi-billion dollar commerce is legitimate, but the temptations are great when CFZ merchants sell on razor-thin margins and so much CFZ trade comes from Asian countries (adept at mass production of counterfeit goods) and goes to Andean countries (eager to launder their illicit drug proceeds). CFZ merchants will continue to give into these temptations until the perceived risk is greater than the very lucrative payoffs. Indeed, CFZ merchants have staunchly resisted proposals to reduce criminal activity by increasing security, claiming that they cannot afford the increased user fees that such security improvements would require. That is changing though*in 2003 the CFZ opened doors to the Business Anti-Smuggling Coalition (BASC), as the zone recognizes that without transparency, companies may be further exposed to liability. Also helping is the new PRD Torrijos administration,s anti-corruption efforts, and naming of highly respected Colon activist Nilda Quijano to the administrator post at the CFZ. Finally, the relative stability of Venezuela and Colombia in recent months is leading to rebounding imports and export. Until the CFZ merchants overhaul their business model and the CFZ administration addresses its security and law enforcement weaknesses, the Zone,s reputation for lawlessness will cloud its future by discouraging potential new customers and investors needed for expansion.

ANNEX: Selected CFZ Statistics

(Sources: Ministry of Economy and Finance, Comptroller of the Republic, CFZ Administration)

In $ millions	1997	1998	1999	2000	2001	2002	2003e
CFZ imports	5,398	5,211	4,166	4,630	4,760	4,410	3,990
CFZ reexports	6,276	5,985	4,950	5,318	5,451	4,820	4,478

(In millions, 1996 as base year)

Panama GDP	9,916	10,648	11,071	11,374	11,440	11,697	12,172
CFZ Contrib.	810	803	694	805	894	855	895
As a pct	8.2	7.5	6.3	7.1	7.8	7.3	7.4

Top sellers to the CFZ:
(% of total 2003 CFZ imports by value)

Asia:
--Hong Kong 23.4%
--Taiwan 15.2%
--Mainland China 13.0%
--Japan 4.5%
--South Korea 3.4%
--Thailand 0.9%
--Singapore 0.6%

Europe:
--Italy 2.5%
--France 2.4%
--Switzerland 2.1%

North America:
--USA 9.8%
--Mexico 2.0%

Top buyers from the CFZ:
(% of total 2003 CFZ re-exports by value)

South America
--Colombia 14.1%
--Ecuador 7.9%
--Venezuela 5.6%
--Chile 3.1%
--Brazil 2.0%
--Paraguay 0.4%

Central America/Caribbean
--Panama 8.4%
--Guatemala 6.9%
--Costa Rica 5.4%
--Cuba 5.2%
--El Salvador 3.6%
--Nicaragua 3.4%

North America:
--USA 4.5%
--Mexico 2.6%

WATT